

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]
[REDACTED]

date:

to: Chief, Examination Division, [REDACTED] District
Attn: [REDACTED]

from: Assistant District Counsel, [REDACTED] District

subject: [REDACTED]
Nonrecourse and Recourse Debt

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This memorandum responds to your September 24, 1999 inquiry regarding potential for debt to be classified as recourse for purposes of Treas. Reg. § 1.861-10T while classified as nonrecourse for purposes of Subchapter K.

ISSUE:

Whether it is possible for debt to be classified as recourse indebtedness for purposes of Treas. Reg. § 1.861-10T, while being classified as nonrecourse indebtedness for purposes of Subchapter K.

CONCLUSION:

Because of the different standards used, we believe it is possible for debt to be classified as recourse indebtedness for purposes of Treas. Reg. § 1.861-10T, while simultaneously being classified as nonrecourse for purposes of Subchapter K.

FACTS:

Although the instant inquiry turns on the statutory language of the particular Code sections involved and not on the facts of any particular transaction, we repeat here a recitation of two particular sale-lease back transactions for which information is known, strictly for the sake of the reader. We recognize that the taxpayer participated in hundreds of similar transactions during the current cycle, and in increasing numbers during future years.

TRANSACTION #1.

On [REDACTED], in a transaction to which [REDACTED] was apparently not party, [REDACTED] (" [REDACTED] ") executed a purchase agreement (Purchase Order No. [REDACTED]) with the [REDACTED] for the production of a [REDACTED], Serial Number [REDACTED]. The sales price was slightly less than \$ [REDACTED].

Several relevant agreements were executed "as of [REDACTED]". First was an Agreement to Purchase and Lease, entered into between [REDACTED] and [REDACTED]. [REDACTED] was one of [REDACTED]'s subsidiary corporations. Under this agreement, [REDACTED] agreed to purchase and [REDACTED] agreed to lease the [REDACTED] for which [REDACTED] already possessed a purchase order. Second, a Purchase Agreement Assignment was executed by [REDACTED] as of [REDACTED], assigning [REDACTED]'s rights and duties under its agreement to purchase the [REDACTED] to [REDACTED]. Third, a Lease Agreement (the "Lease") between [REDACTED] and [REDACTED] was executed under which [REDACTED] became obligated to pay rent for the [REDACTED] for [REDACTED] years, commencing on [REDACTED] and ending [REDACTED].

Also dated "as of [REDACTED]" was a Partnership Agreement, executed by [REDACTED], one of [REDACTED]'s domestic subsidiaries, and [REDACTED] (" [REDACTED] "), forming [REDACTED] (" [REDACTED] "). For its contribution of \$ [REDACTED], [REDACTED] became a [REDACTED]% limited partner in the partnership. [REDACTED] invested \$ [REDACTED] to obtain a [REDACTED]% general partnership interest, and \$ [REDACTED] to obtain the remaining [REDACTED]% limited partnership interest.

As of the same date, [REDACTED] executed a Trust Agreement with [REDACTED], forming a grantor trust with [REDACTED] as Trustee. The Trustee executed a Loan Agreement, as of [REDACTED], to borrow \$ [REDACTED] from [REDACTED] (the "[REDACTED] loan") on behalf of the [REDACTED] partnership. While the [REDACTED] loan was without recourse to [REDACTED], it was collateralized by a separate Pledge Agreement, in effect as of the same date, which pledged the stock of [REDACTED]. The Trustee also executed a Borrower Security Agreement as of [REDACTED], which provided the [REDACTED] lenders a security interest in the amounts on deposit in [REDACTED] account, in which account any and all dividends from [REDACTED] were required to be held.

The Trust immediately invested its original equity contributions and the proceeds from the [REDACTED] loan in [REDACTED]. [REDACTED] used the funds obtained from the Trust to fund its purchase of the [REDACTED].

THE LOAN TERMS

As already mentioned, the loan was without recourse to [REDACTED]. The loan carried a [REDACTED] maturity date and an initial interest rate of [REDACTED]%, per annum, subject to adjustment to reflect current market conditions, once the Interim Term and Basic Term of the Lease ended. Payments under the loan were due on an annual basis, beginning on [REDACTED].

THE LEASE TERMS

The Lease was a "net lease", requiring [REDACTED] to bear responsibility for insurance, maintenance and taxes on the leased [REDACTED]. Lease payments were described as "Basic" and "Interim". The Interim term ran from [REDACTED] until [REDACTED]. The Basic term commenced on [REDACTED] and ended [REDACTED] years later on [REDACTED]. Under the Interim term, lease payments in the amount of \$ [REDACTED] and \$ [REDACTED] were due on [REDACTED] and [REDACTED]. Lease payments under the Basic term were calculated by multiplying the lessor's cost (\$ [REDACTED]) times a predetermined percentage, ranging from approximately [REDACTED]% to [REDACTED]%. Basic term lease payments began on [REDACTED] and were required yearly thereafter, tendered to the [REDACTED], for [REDACTED].

At the end of the Basic term, [REDACTED] had three options:

- (1) [REDACTED] could purchase the [REDACTED] for [REDACTED]% of the lessor's cost of \$ [REDACTED];

(2) [REDACTED] could lease the [REDACTED] or provide an unrelated new lessee, for an [REDACTED] year lease at a predetermined lease amount; or

(3) [REDACTED] could return the [REDACTED] to [REDACTED] with a specified payment of [REDACTED]% of the lessor's cost.

TRANSACTION #2.

[REDACTED], [REDACTED] (" [REDACTED] ") executed Purchase Order [REDACTED] with the [REDACTED] regarding the manufacture of a [REDACTED], registration ID number [REDACTED], manufacturer's serial number [REDACTED].

A Participation Agreement, dated as of [REDACTED], was executed by [REDACTED], [REDACTED], a [REDACTED] subsidiary of [REDACTED], and [REDACTED], as Trustee. The Participation Agreement outlined the general transaction, including that [REDACTED] would assign the purchase order for the [REDACTED] to the [REDACTED] subsidiary and immediately lease it back.

In a Trust Agreement dated as of [REDACTED], [REDACTED] and [REDACTED], as trustee, established a trust for the benefit of [REDACTED]. A Loan Agreement, also dated as of [REDACTED], between the Trustee and [REDACTED] arranged for the loan of approximately \$ [REDACTED] for the benefit of [REDACTED]. Attached to the Loan Agreement was a Pledge Agreement. The Pledge, signed by the trustee, noted that the Trustee held all of the stock of [REDACTED] and, as a condition to receiving the bank loan, the Trustee pledged that capital stock to secure the loan. In addition to the Pledge, the Trustee executed a Borrower Security Agreement in favor of the lender, [REDACTED]. According to the Security Agreement, to secure the obligations under the loan, the trustee granted the bank a security interest in all amounts deposited in [REDACTED] account, an account into which all dividends from [REDACTED] were required to be deposited.

A Purchase Agreement Assignment was executed as of [REDACTED], under which [REDACTED] assigned to [REDACTED] all of its rights under its purchase order with [REDACTED] for the [REDACTED]. Parenthetically, prior to the eventual purchase of the [REDACTED] by [REDACTED], the [REDACTED] transferred the [REDACTED] on [REDACTED], to its own sales subsidiary, [REDACTED], which transferred the [REDACTED] on [REDACTED], to an entity consisting of [REDACTED], [REDACTED] and [REDACTED]. Apparently legal title to

the [REDACTED] was eventually transferred from the [REDACTED] entity to [REDACTED].

Also executed as of [REDACTED] was a Lease Agreement which obligated [REDACTED] to lease the [REDACTED] from [REDACTED] for a period commencing on the delivery date and running approximately [REDACTED] years. The term of the lease could neither be extended nor renewed. Rent was calculated as the product of the lessor's cost (\$ [REDACTED]) multiplied by a predetermined percentage, ranging from less than [REDACTED]% to over [REDACTED]%. Generally, rent was to be paid semiannually.

[REDACTED]'S INVOLVEMENT IN THE TRANSACTION.

In a document dated as of [REDACTED], a partnership was formed among [REDACTED], as general partner ([REDACTED]% interest, \$ [REDACTED] contributed), [REDACTED] as a limited partner ([REDACTED]% interest, \$ [REDACTED] contributed), and [REDACTED], as a limited partner ([REDACTED]% interest, \$ [REDACTED] contributed). [REDACTED] was a wholly owned domestic subsidiary of [REDACTED], although, the date of its incorporation is unknown. The stated purpose of the partnership, known as "[REDACTED]", was to act as a trustee under a Trust Agreement and enter into Purchase and Lease Agreements regarding [REDACTED].

In a Purchase Agreement dated as of [REDACTED], [REDACTED] purchased [REDACTED]'s interest in a trust for which [REDACTED] had been appointed Trustee. In return for the trust shares, [REDACTED] paid [REDACTED] \$ [REDACTED].

An Amendment to the Participation Agreement (originally dated as of [REDACTED] among [REDACTED], [REDACTED], a [REDACTED] subsidiary of [REDACTED], and [REDACTED], as Trustee) was executed by [REDACTED], [REDACTED], and [REDACTED]. According to the Amendment, dated as of [REDACTED], [REDACTED] assumed the obligations of [REDACTED] through an Assignment and Assumption (a document executed on [REDACTED]). Thus, [REDACTED] took the role originally held by [REDACTED]. [REDACTED] became a FSC of [REDACTED].

Amendment No. 2 to Loan Agreement, dated as of [REDACTED] was executed, generally replacing references to [REDACTED] or the "company" with references to [REDACTED] or the "partnership."

TAXPAYER'S POSITION:

Taxpayer suggests that the above loans should be classified as: (1) recourse for purposes of Treas. Reg. § 861-10T because the pledge of the stock and assets of the single asset companies amounted to either cross collateralization or a credit enhancement and (2) nonrecourse for purposes of Subchapter K. At issue is whether the same loan may be classified as recourse for one Code section and nonrecourse for other provisions of the Code.

ANALYSIS:Section 861:

For purposes of section 861, a determination of whether a loan is recourse or nonrecourse directly affects the sourcing of income. Generally, under section 861, since money is fungible, interest expense is attributable to all activities and property regardless of any specific purpose for incurring the obligation on which the interest is paid. Such interest expense is generally allocated on the basis of all assets of members of the affiliated group. Treas. Reg. § 1.861-10T provides a number of exceptions to that general rule and allows interest expense to be allocated directly to the income generated by certain assets, subject to what is called "qualified nonrecourse indebtedness." Paraphrasing Treas. Reg. § 1.861-10T(b)(1), in the case of qualified nonrecourse indebtedness, the deduction for interest is directly allocable solely to the gross income which the property acquired, constructed or improved with the proceeds the indebtedness has generated or could reasonably be expected to generate.

Treas. Reg. § 1.861-10T(b)(2) defines the term "qualified nonrecourse indebtedness" as, with certain exceptions found in Treas. Reg. § 1.861-10(b)(4), any borrowing if:

- (i) the borrowing is specifically incurred to purchase, construct or improve identified tangible personal property or real property with a useful life greater than one year;
- (ii) the proceeds are actually applied to purchase, construct or improve the identified property;
- (iii) the creditor can look only to the identified property as security for payment of the principal and interest on the loan and cannot look to any other property, the borrower, or any third party for repayment of the principal or interest;

(iv) the cash flow from the property is sufficient to cover the terms of the loan; and

(v) the loan agreement has restrictions on the use and disposal of the property consistent with (iii) and (iv).

Nevertheless, even if the loan satisfies the five factors set forth in Treas. Reg. § 1.861-10T(b)(2), and would normally constitute qualified nonrecourse indebtedness, the loan may be excluded from consideration if it fails any of the requirements of Treas. Reg. § 1.861-10T(b)(4). Excluded by that subsection are transactions:

- (i) lacking economic significance;
- (ii) involving cross collateralization;
- (iii) involving credit enhancements;
- (iv) involving the purchase of inventory;
- (v) involving the purchase of financial assets; and
- (vi) involving qualified residential indebtedness.

Since the taxpayer suggests that the above loans were cross collateralized or involved credit enhancement, only those two exceptions are relevant.

In that regard, cross collateralization refers to a pledge as security for a loan of:

- (i) any asset of the borrower other than the identified asset; or
- (ii) any asset belonging to any related person as defined in Treas. Reg. § 1.861-8T(c)(2).

See Treas. Reg. § 1.861-10T(b)(6) (underline added).

In other words, if some asset of the *borrower or a related party* besides the identified property is pledged for the loan, the loan is cross collateralized and the loan cannot be qualified nonrecourse indebtedness.

Generally, the term "credit enhancement" is defined to mean:

any device, including a contract, letter of credit, or guaranty that expands the creditor's rights, directly

or indirectly, beyond the identified property purchased, constructed, or improved with the funds advanced and, thus, effectively provides as security for a loan the assets of any person other than the borrower.

Treas. Reg. § 1.861-10T(b)(7)(i).

From the above, it is evident that the methodology set forth to implement section 861 requires that indebtedness be classified as either recourse or qualified nonrecourse indebtedness, with recourse being the "default" category. That is, all indebtedness which fails to satisfy the relatively narrow definition of qualified nonrecourse indebtedness set forth in Treas. Reg. § 1.861-10T(b)(2), will be considered "recourse" indebtedness for purposes of applying section 861. One practical effect of the mechanical nature of the standards set forth in Treas. Reg. § 1.861-10T(b)(2) is that it provides taxpayers with the ability to cause each individual indebtedness to be classified as recourse or nonrecourse, as they choose, simply by causing the indebtedness to satisfy or deliberately fail the regulation's standards.

The agents and the taxpayer agree that the pledging of the single asset companies' stock and assets constitutes cross collateralization, eliminating the possible consideration of the loans as qualified nonrecourse indebtedness. For purposes of this memorandum, we accept your conclusion that the pledging of the single asset companies' stock and assets constitutes cross collateralization.¹

Subchapter K:

Subchapter K, entitled "Partners and Partnerships" controls the reporting of partnership profits and losses. As you noted, generally, a partner's distributive share of partnership losses is allowed only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership loss in which the loss occurred. See section 704(d). Likewise, the rules required to be followed in determining a partner's adjusted basis are set forth in section 705.

¹ Treas. Reg. § 1.861-10T(b)(6) is clear that the pledge of ANY ASSET of the borrower other than the identified asset constitutes cross collateralization. Here, it is reasonable to conclude that the pledge of the stock of the single asset company constitutes cross collateralization.

By definition, a partnership liability is "recourse" liability to the extent that any partner or related person bears economic risk of loss for that liability under Treas. Reg. § 1.752-2. Likewise, a partnership liability is "nonrecourse" liability to the extent that no partner or related person bears economic risk of loss for that liability under Treas. Reg. § 1.752-2.

To determine whether a partner or related person bears economic risk under Treas. Reg. § 1.752-2, thereby resolving the question of whether the liability is "recourse" or "nonrecourse", requires the application of a structured formula. In general, to make such a determination, the partnership is required to be treated as if it were constructively liquidated and any obligations to make payments by partners are observed. See Treas. Reg. § 1.752-2(b)(1).

Although the application of the formula is neither simple nor without exceptions, by mechanical application of the formula, the indebtedness is either found to be recourse or nonrecourse for purposes of Subchapter K. In the instant matter, apparently the taxpayer and the agents agree that applying the constructive liquidation methodology set forth in Treas. Reg. § 1.752-2(b) results in the indebtedness being considered nonrecourse for purposes of the application of Subchapter K.

Application:

Neither the regulations under section 752 nor those under section 861 cross reference the other Code section. There seems to be no inherent reason to fashion the argument that satisfaction of the definition of "recourse" for purposes of one of the Code sections would presuppose, predetermine or even affect the determination under the other Code section's definition. The two Code sections have different purposes and accordingly use differing definitions which can easily result in apparently conflicting results.

We found no case law or National Office pronouncement which suggests that the rules of either Code section may be ignored due to the conflicting results which may naturally exist upon application of the different approaches required by the other Code section. Lacking either statutory or case specific support for the position argued by the agent, we must conclude that the application of section 752 (Subchapter K) and section 861 can and will result in conflicting conclusions regarding the classification of indebtedness as recourse or nonrecourse indebtedness.

Stated differently, we conclude that the determination of whether an indebtedness is recourse or nonrecourse for purposes of Subchapter K is a function of the rules in effect for that Subchapter and that determination is not affected by the functionally parallel rules which control the same determination for purposes of section 861.

SUMMARY:

Based upon our review of the rules required to be followed in applying Code section 861 and Subchapter K, we conclude that the application of the two different mechanical formula approaches to determining whether an indebtedness is recourse or nonrecourse for purposes of Subchapter K and section 861 may result in apparently conflicting results.

[REDACTED]
Assistant District Counsel

By: _____

[REDACTED]
Special Litigation
Assistant